Shell Offshore Inc.

An affiliate of Shell Oil Company

PO Box 61933
New Orleans LA 70161-1933

One Shell Square
701 Poydras Street
New Orleans, LA 70139

Direct Number: (504) 588-6982
Direct FAX: (504) 588-4567

Exploration and Production
Shelf Division
Regulatory Affairs Department

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VIA FAX (303) 231-3194 AND AIRBORNE EXPRESS

Mr. David J. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
Building 85 - Denver Federal Center
P. O. Box 25165 - Mail Stop MMS-3101
Denver, CO 80225

Dear Mr. Guzy:

RE: COMMENTS ON MMS PROPOSAL
"AMENDMENTS TO TRANSPORTATION ALLOWANCE REGULATIONS FOR FEDERAL AND INDIAN LEASES TO SPECIFY ALLOWABLE COSTS AND RELATED AMENDMENTS TO GAS VALUATION REGULATIONS"
30 CFR PARTS 206 - 61 FR 39931 (JULY 31, 1996)

These comments are submitted on behalf of Shell Oil Company and its wholly owned subsidiaries, Shell Offshore Inc. and Shell Western E&P Inc. (hereinafter collectively referred to as "Shell").

Shell has participated in and reviewed the comments prepared by the American Petroleum Institute ("API") and fully supports API's comments on the expansion of and radical departure from prior MMS and Interior interpretation of the lessee's obligation to place hydrocarbons in marketable condition at no cost to the federal government. The current amendment to §206.152(i) substantially expands that obligation by purporting to require the lessee "to market at no cost" to the federal lessor. There is no pre-existing regulatory support in the so called marketable condition rule which imposes such an expansive duty on the lessee to provide free services to the lessor over and above putting the hydrocarbon in marketable condition. The obligation to market for the mutual benefit of both the lessor and the lessee does not carry with it an obligation to market free of charge on the lessor's behalf. Under traditional oil and gas principles lessees have an implied obligation to market lease production for the mutual benefit of both parties. However, such implied obligation has never been viewed as embodying a concept that such marketing must be done for the lessor free of charge. Traditional oil and gas principles placed such burden on the lessee because it was more properly identified as a production cost but recognized that the lessor shared marketing cost proportionate with the lessee.

The proposed rule leaps from the realities of past precedent and general oil and gas law by merely stating it is "implied". The obligation to market for the mutual benefit of the lessor and lessee does not imply that the lessor is entitled to free ride for the sharing of all marketing costs.

There is no existing obligation on the part of a federal lessee to market production free of charge that goes beyond placing the production in marketable condition. MMS cannot by regulation create such an obligation. The MMS and the Department of the Interior's authority is defined in §8(a) of the Outer Continental Shelf Lands Act. This provision provides for payment of royalty at specified percentages "in the amount of value of the production saved, removed or sold from the lease." 43 USC §1337(a). The MMS has no authority to impose royalty on anything other than the value of production saved, removed or sold from the lease premises. The Fifth Circuit Court of Appeals in Diamond Shamrock Company v. Hodel, 853 F.2d 1159 (1988) specifically found such efforts to be in excess of the agency's authority.

The net effect of this proposed regulation to market "free of cost" is an attempt to impose royalty on the value of marketing services long after production has been saved, removed and sold from the lease premises. Under §206.152(i) increasing royalty value to the extent of the cost "to market the gas" is clearly beyond the agency's statutory authority which is limited to valuing production on what has been saved, removed or sold from the lease itself. Such an effort is a clear attempt to assess royalty not on production but on marketing services which are performed away from the lease. Such assessment in many instances would occur after the production has already been placed in a marketable condition and even after it has been removed away from the leased premises. As such, assessment of royalty cannot be authorized or supported by the statute or the terms of a lease.

Over the past several years, the agency has been engaged in rulemaking efforts to establish greater certainty in royalty assessment and value. The current rule runs directly counter to prior established goals of the regulated community, the state and the agency to move more closely to regulations which allow greater certainty in valuation of hydrocarbons. Since the extent of this new obligation to market "free of charge" is completely undefined, it will undoubtedly lead to endless controversies over what should be included in value for purposes of royalty assessment and what should be excluded. Lessees will be left without compass, without steering and without light in a dark sea of "no cost to the federal lessor". There will be no way to determine what services performed after production and removal of the hydrocarbon fits into the category of free market services which are royalty assessable.

Shell strongly urges the MMS not to promulgate a retroactive rulemaking. FERC Order 636 was issued in May, 1992, but was not fully implemented until later. No MMS agency guidance has been provided to the oil and gas industry until the present rulemaking. Shell regards the current rulemaking as substantitive in nature and not interpretative. Without the current amendments to the valuation regulations, the MMS has no clear authority to collect royalty in many of the areas described in the proposed regulation. To retroactively impose royalty obligations on a lessee violates existing precedence on retroactivity of law and deprives lessees of their property in excess of MMS's statutory authority. The concepts embodied in this rulemaking of assessing royalty based on the concept of marketing at no cost to the federal lessor as described above is totally new ground not even fully supported by existing oil and gas law. To now retroactively apply this back to May, 1992, is overreaching and unsupported in law.

Attached hereto are Shell's comments on individual provisions impacting different types of Order 636 charges. Shell appreciates the opportunity to offer comments on the proposed rulemaking.

Sincerely yours,

Peter Velez

Peter K. Velez
Regulatory Affairs Manager

Attachment

INDIVIDUAL COMMENTS

Firm Demand Charges and Capacity Release Program and Pipeline Rate Adjustments - 30 CFR §206.157(f)(1) and §206.177(f)(1)

Firm Transportation ("FT") is secured only when a lessee believes that movement of both the working interest as well as the royalty share may require payment of this higher FT rate. The lessees own economic benefit requires that such arrangements be entered into after careful consideration of all transportation options. The federal lessor should not object to proportionately sharing the entire cost of FT even if only a portion is used since the royalty share is benefiting from the FT cost borne by the federal lessee. It is only in those circumstances where the lessee's actual cost for the FT has been reduced by a credit under some type of capacity released program that the allowance should be reduced accordingly. Firm transportation contracts do not allocate between used and unused capacity. They clearly specify that the entire FT charge is consideration for transportation irrespective of how much the capacity is used. Therefore, the federal royalty portion should bear its share of the expense in the same manner as the working interest share. Shell agrees that payments or credits from pipeline penalty refund and rate cases should be reflected in a reduction on royalty. We agree that the requirement to retroactively correct previously filed forms is administratively burdensome and has little value added in meeting MMS's objective to simplify and streamline royalty production. We believe such a requirement is not cost effective and recommend that for federal OCS leases that the lessee be allowed to report the adjustment in the month received and allocate it to the leases on which it had been paid.

Gas Supply Realignment Cost - 30 CFR §206.157(f)(2) and §206.177(f)(2)

Shell agrees with the proposed treatment for gas supply realignment ("GSR") as allowable transportation costs. We do disagree with the commentary in the preamble which purports to tie their treatment to gas contract settlements. The deductibility of these costs should not be tied to royalty consequences of pending litigation.

Actual or Theoretical Losses (30 CFR §206.157(f)(7) and §206.177(f)(7)

Shell agrees with inclusion of these losses as part of arm's-length contracts in FERC or state regulatory tariffs but disagrees that they should be automatically disallowed if part of a non-arm's-length contract. Actual losses should be allowed in all circumstances as long as the lessee is able to demonstrate that a loss has actually occurred. Theoretical losses, if based on sound estimates of losses incurred but not easily measured in all types of transportation situations, should be allowed.

Supplemental Services Necessary for Transportation - 30 CFR §206.157(f)(8) and §206.177(f)(8)

Shell agrees that such costs should be included in the transportation allowance. However, Shell believes that all compression dehydration and treatment costs should be included in the transportation allowance as long as the purpose of these costs were related to transportation and not to put the gas in marketable condition.

Banking and Parking Fees - 30 CFR §206.157(g)(1)(ii) and §206.177(g)(1)(ii)

Shell disagrees that short term storage fees, banking/parking, should be disallowed as part of the transportation costs. These costs are similar to wheeling charges. There is usually no physical stopping of the gas and it is often no more than a paper occurrence. If banking and parking are not used in this fashion, then a producer's option is to throttle down wells and/or shut down production to allow the gas to flow smoothly. This would actually result in lost revenue in a current month for MMS. Under these circumstances such short term storage fees should be allowed.

Aggregator/Marketer Fees - 30 CFR §206.157(g)(2) and §206.177(g)(2)

FERC penalties should be disallowed only in the cases when there has been negligence on the part of the producer. This section treats cash out penalties, scheduling penalties and imbalance penalties and curtailment and operational flow orders. In the cash out penalties for over and under deliveries, MMS proposes accepting cash out within tolerance of tariff level but disallows cash out in excess of tolerance where there is a substantial price reduction. MMS asserts that such failure to avoid over/under delivery is a violation of the duty to market for the benefit of a lessor and lessee and that transporters can always negotiate out of these kinds of penalties. Shell disagrees. The regulation should disallow outside of tolerance only when they are the result of the gross negligence of the lessee/transporter. All of these penalties are an actual cost of transportation and often occur through no fault of the federal lessee who is acting in the utmost good faith and as a wise and prudent operator. It would be particularly burdensome to retroactively apply this provision in light of the record keeping and administrative burden it would create.

Intra-hub Title Transfer Fees - 30 CFR §206.157(g)(4) and §206.177(g)(4)

The intra-hub title transfer fees are not marketing costs but rather are costs necessary to transport gas through a hub to any one of several potential pipelines in order to maximize revenue from the sale of gas. A disallowance of such fees punishes aggressive marketers who seek to get the highest price by moving from the hub to a better market. It is essential that the hub operator track the title transfer of the gas as it moves through the hub to operate in an efficient transportation system. This fee is essential to efficient management of the transportation process and should be an allowable cost of transportation.

Other Non-Allowable Costs - 30 CFR §206.157(g)(5) and §206.177(g)(5)

All costs incurred to market production after it has been placed in marketable condition should be allowed. This carte blanche denial of such charges would be based upon an invisible line which would be indeterminent by the lessee. The example given by the MMS illustrates this problem. Any other result will require payment of royalty on a value in excess of the value of production saved, removed or sold from the lease.